Finance for Growth

- Governments need to do
  - More and better in some areas
  - Less in others
- And to recognize how finance without frontiers is changing what they can do, and can achieve
- Because finance matters for growth and poverty reduction, and we have the evidence

Main messages

- Well functioning markets need:
  - legal and regulatory underpinning
  - strategy based on harnessing incentives
- Diversity is good for stability and development
- Good safety nets require good institutions
- Governments are not good at providing financial services, even when a crisis hits
- Open markets, technology can spur development–

What it does not say

- Not to ‘leave finance to the market.’
- Not to privatize banks all at once
- Not just open up to entry to foreign financial firms and leave it to them.
- Not just open to capital flows without robust regulatory system.

What government needs to do

- Finance is about changing money today for money tomorrow

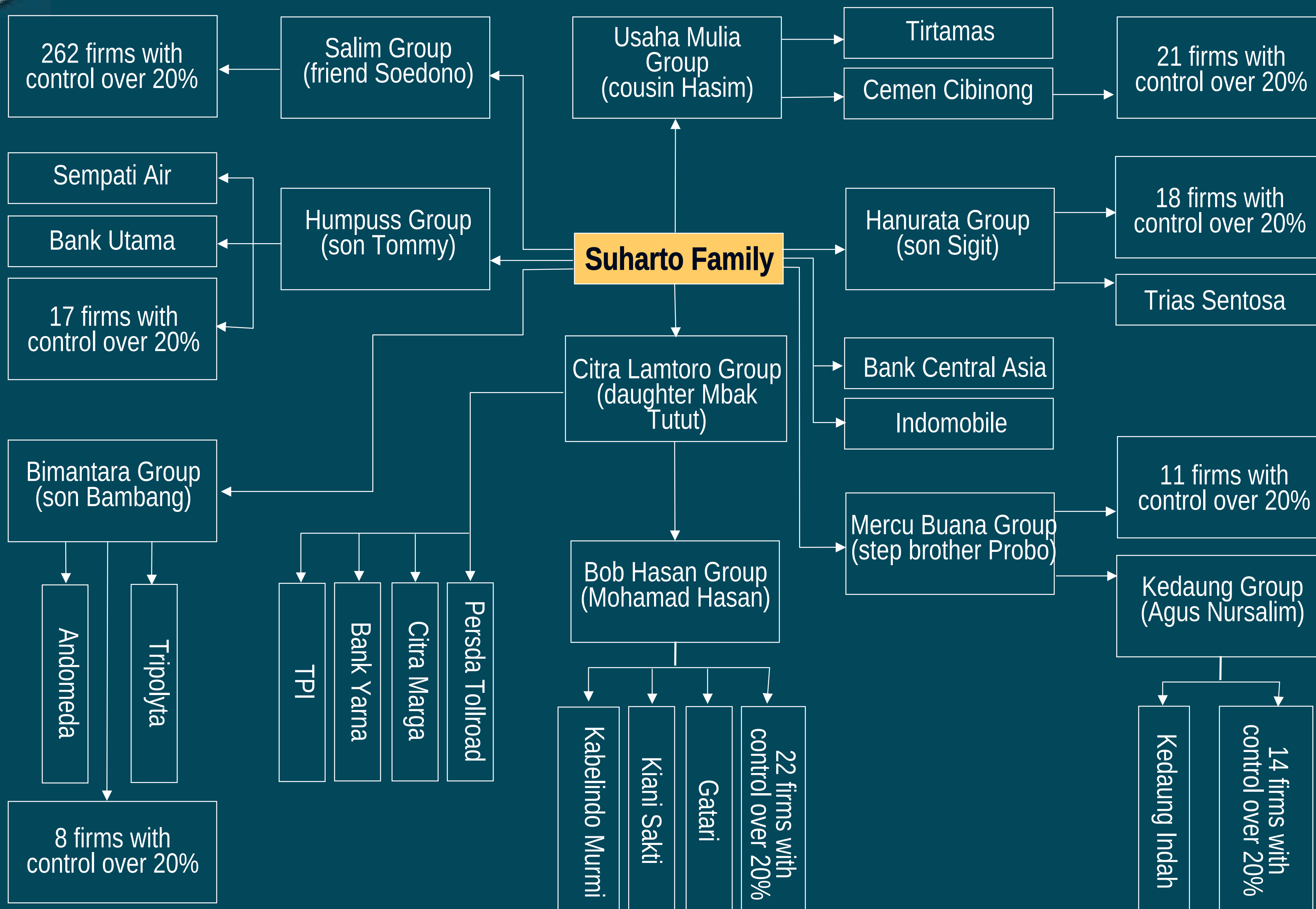
  ⇒if information or contract enforcement is lacking, no credit is the result

- Finance boosts growth by
  - Widening access to external finance (more firms, more sectors)
  - Raising productivity
    - not the scale — of investment

But beware!

- Bigger is not necessarily better
- Focus on effectiveness – not size
- Beware of:
  - too rapid credit growth…
  - forcing the pace with state-owned banks
  - tilting the system to one particular type of structure not advised – both bank and market based systems have worked.
  - recognize that most governments implicitly or explicitly subsidize banking

"And the owner is... the Suharto family group"



What to do

- Better to build a solid infrastructure

  ...than to aim for a particular structure

- Improving the information infrastructure and technology can lower intermediation costs –

  – outweigh potential drawbacks (lost privacy and credit discrimination)

➢ The better the infrastructure, the greater the *sustainable* reach of the sector.

Towards better banking

- FFG focused attention on the role of incentives for all the actors – owners, markets, and supervisors
- Too often, we note but then give up on key incentive issues, such as:
  - Skewed balance of terror for supervisors
  - Adoption of deposit insurance before regulatory framework in place; subsidization skews financial system.
- Generally, markets better at oversight than acknowledged $\Rightarrow$ give them more support.

Bureaucrats as bankers: the evidence

Greater state ownership leads to:

- less financial sector development, lower growth, lower productivity
- higher interest rate spreads, less private credit, less nonbank financial development
- greater concentration of credit
- some tendency towards more crises, weaker monitoring

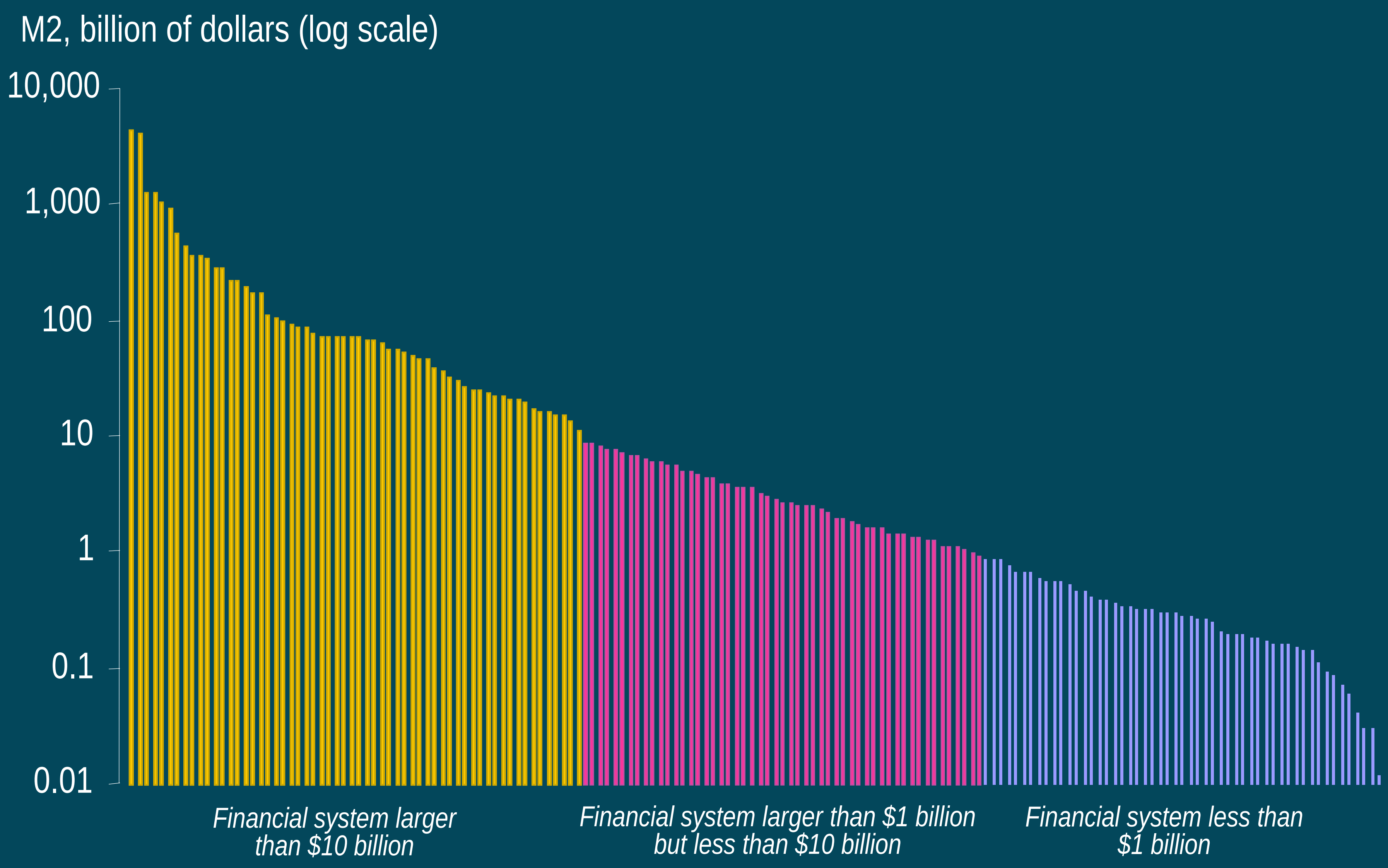
Evidence that State Banks can be reformed

Finance without frontiers

- What services to buy, and what to build at home
  - What matters for growth is access to financial services, not who supplies them
- Most emerging markets are too small to afford a closed financial system with exclusively ‘domestic’ banks and other intermediaries

FINANCE for GROWTH

National financial systems ranked by size



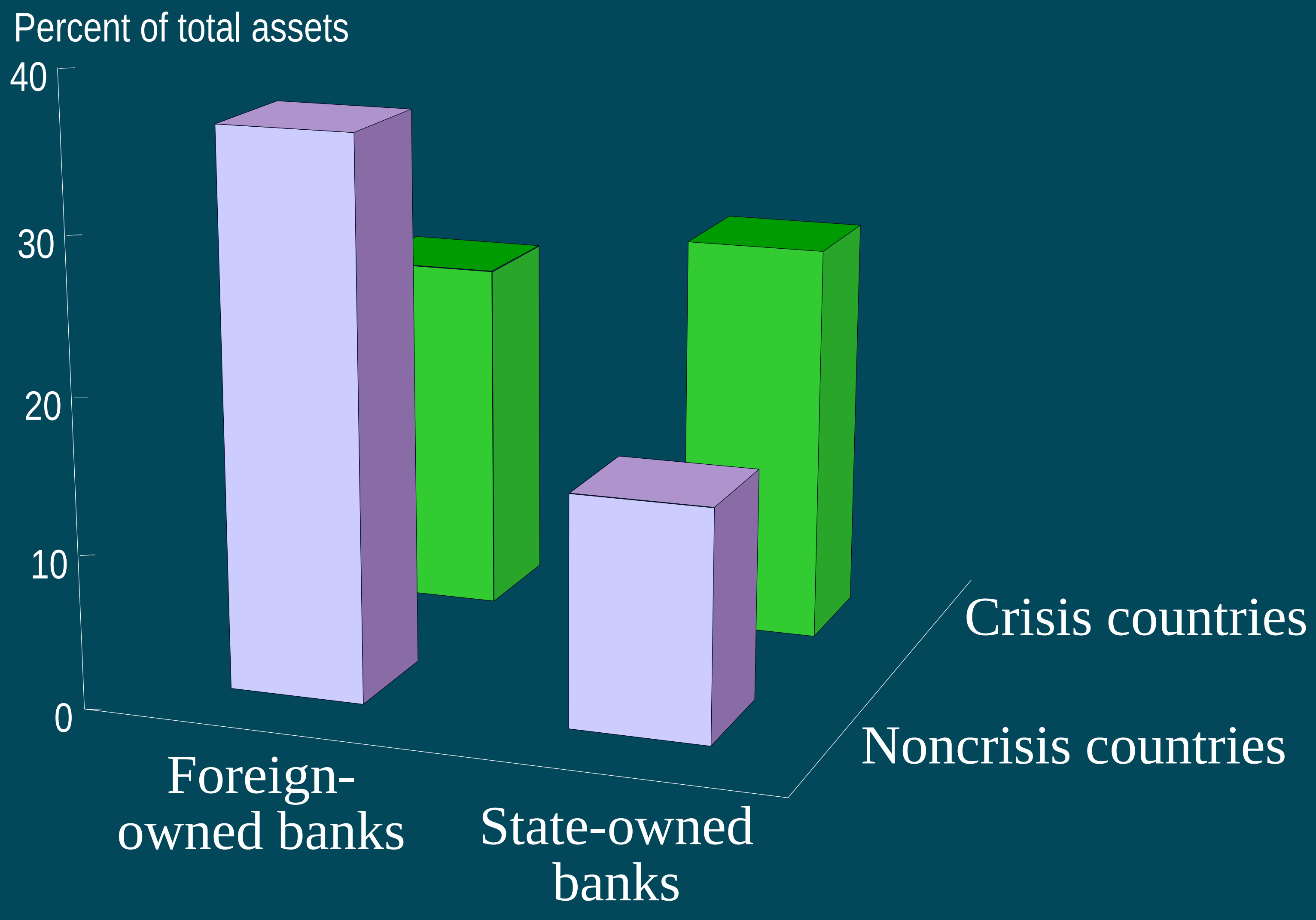
Financial services: foreign provision

- Emerging markets can benefit from importing financial services

- Despite worries that foreign firms could destabilize domestic finance –

  – there is little evidence to support such fears… in fact, it goes in the other direction!

Comparing the share of foreign and state ownership in crisis and noncrisis countries



Implementing Finance for Growth

- Return to basics: help improve information environment and contract enforcement
  - If a large percentage of our efforts are not spent on infrastructure, we are missing the point
- Start and end with incentives: don’t drop the ball even when it is hard (e.g. supervisors)
- Build consensus for sensible financial sector reforms
  - Entails more reaching out beyond finance ministeries and central banks to civil society.